

BASEL COMMITTEE ON BANKING SUPERVISION

The Chairman

Via electronic mail

Mr Peter Johnston,
Chief Executive of IFAC

Mr Brian Smith, Secretary of the
Provisional Forum of Firms
International Federation of Accountants

2 November 2001

IFAC's Consultation on the Public Oversight Board, Forum of Firms and Transnational Auditors Committee

Dear Messrs Johnston and Smith,

The Basel Committee is pleased to offer its comments on IFAC's proposals for the Public Oversight Board, Forum of Firms and Transnational Auditors Committee. We support the IFAC's goals of improving international audit quality and transnational audits. The success of IFAC's proposals will of course only be demonstrated over time.

Please find our comments in the attached note. The note has been prepared by the Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank.

The consultation period has, regrettably, been very short, especially in light of recent events. Our comments therefore focus on the major aspects of the proposals. The Accounting Task Force may develop additional comments during the month of November.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+ 31 20 524 3360) or Bengt A Mettinger at the Basel Committee Secretariat (+ 41 61 280 9278).

Yours sincerely,



William J McDonough

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General comments

Independent high quality audits of financial statements contribute to the effective functioning of the financial system generally and capital markets in particular. The audit function serves not only shareholders and potential investors but also other stakeholders and the public in general by enhancing the reliability and credibility of published financial information. As a consequence of these and other factors, independent high quality audits are a key concern for banking supervisors and central banks alike.

The auditing profession has - for several reasons - developed significantly over the last few decades. The reasons include the continuously increasing complexity of financial accounting and reporting standards and the types of commercial transactions now frequently used by businesses. Business enterprises' dependence on modern information technology and the size, complexity and truly international character of numerous enterprises have also contributed to the changes in the profession. There is no doubt that the resulting professional development in many countries often has been remarkable.

The globalisation of the economy has resulted in a number of mergers of auditing firms as these firms seek to service clients on a worldwide basis. At the same time, competition between major firms has increased as competitive bidding for audit assignments has become more common in many countries. In addition, auditing firms have significantly broadened their offerings to include consulting and other non-assurance services.

This environment underlines the importance of high quality auditing standards worldwide and the enforcement of these standards. In many countries the standards may be poor and their enforcement weak or nonexistent. These shortcomings are clearly unsatisfactory from a financial stability perspective.

While addressing these shortcomings may be difficult on a national level, it is even more so in an international context. Part of the reason for this is the differences between countries in the design, regulation and enforcement of auditing standards. While in some countries the state has allocated the responsibilities entirely to a governmental agency, in other countries the responsibilities rest with self-regulatory bodies, albeit under the supervision of government agencies or regulators. There are also differences between countries in the legal responsibilities of auditors.

No single initiative at an international level can remedy all of the problems. Nevertheless, it is important that those steps that can be taken are indeed taken. The Basel Committee welcomes the initiatives that IFAC is now consulting on, but proposes certain modifications as outlined below.

While IFAC's initiatives are useful, they do not replace the need for clear national laws defining the auditors' responsibilities and liabilities, nor do they replace the need for competent national enforcement of auditing standards. The Basel Committee will continue its support for improvements to be made in these areas.

We continue to believe that the quality of IFAC's international auditing and ethical standards and their implementation will be enhanced over time by processes for standards-setting, quality control, compliance and oversight that strive to embrace transparency, independence, and objectivity. For this reason, we believe it is important for the documents that form the

basis of the Public Oversight Board (POB), the Forum of Firms (FOF) and the Transnational Auditors Committee (TAC) to include provisions for these groups to provide periodic public reports on their activities. In addition, the POB, FOF and TAC should include in their written operating procedures requirements for regular meetings with regulators, regulatory organisations such as the Basel Committee and IOSCO, and other key stakeholders to receive input regarding issues relating to the quality of auditing standards and to compliance, quality control and oversight activities. This will help ensure that these IFAC-related organisations enter into a continuing dialogue with international regulatory organisations on these important matters.

Public Oversight Board

The status, objectives and responsibilities of the Public Oversight Board

As designed in the consultative documentation, the POB is an oversight body clearly separated from the management of the activities it is to oversee. We believe that this is the appropriate approach, and that the oversight function of the POB should be kept quite separate from the managerial functions of IFAC that it oversees.

According to the proposal, the initial Chair and other members of the POB will be appointed by the IFAC Board after certain procedures aimed at enhancing the credibility of the selection process are completed. After the initial appointments of the Chair and other members of the POB, subsequent new members will be chosen from a list of one or more persons nominated by a Selection Committee. This committee will consist of the Chair of the POB or the Chair's designate from among the POB members, a former member of the IFAC Board to be selected by the IFAC Board, and a person from the private sector chosen by these two individuals. The POB itself will then elect new members from among the list of nominees submitted by the Selection Committee by a vote of two-thirds of its members in office. Taking into account that the POB is being established to protect the public interest, has only oversight functions and will not have any managerial responsibilities for the activities that it oversees, we believe that both the initial and subsequent appointments to the POB should be made by a process quite separate from the IFAC Board. We recommend, therefore, that the appointment of the initial Chair, Deputy Chair and other members of the POB should be made by a Selection Panel composed of representatives of international and regional organisations that reflect the public interest, including both representatives of securities regulators and of financial institutions regulators. After the initial POB has been established, it should then select subsequent new members in consultation with this Selection Panel.

As described in its Draft Charter, one of the objectives of the POB will be to "maintain and enhance the external profile, credibility and authority of IFAC as the global standard-setting, self-regulatory and representational organisation for the accounting and auditing profession." We do not believe that the objectives of the POB should include maintaining and enhancing the external profile of IFAC, nor should they include maintaining and enhancing the credibility and authority of IFAC as an organisation representing the accounting and auditing profession. In fact, there are important potential conflicts between IFAC's role as a representative of the accounting and auditing profession internationally and the public interest activities that IFAC is currently undertaking and is planning to undertake. These conflicts should not also be introduced into the POB. We believe that the POB will be able to function, and be seen to function, successfully only if its objectives are limited to overseeing the public interest activities of IFAC.

Please note that we are still considering whether there is some further role for the POB in the process of selection and removal of appointees to IFAC committees overseen by the POB.

Adequate financial arrangements

It will be important for the financing of the POB to be fully sufficient and arranged so as to not challenge the independence in fact or appearance of the POB. At this stage, we are unable to comment on the adequacy of the levels of financing indicated in the consultative documents. On the one hand, in order for the important functions of the POB to be carried out in a meaningful way, it will certainly need to employ adequate resources. On the other hand, it is understandable that IFAC cannot necessarily grant any sum that the POB may deem desirable. Thus, our underlying assumption with respect to financing is that IFAC, in establishing this important body, is agreeing to carry those costs that are necessary for the POB to function in a meaningful way. However, contrary to the suggestions detailed in the Draft Charter, we do not believe that the POB's detailed budgets and work programs should be negotiated between the POB and IFAC. How the POB should prioritise its activities within the agreed budget allowance should be a subject for the sole discretion of the POB.

Other important aspects of the proposal for the POB

According to the proposed Charter for the POB, the IFAC Board is entitled to amend the Charter after consultation with the POB. We do not believe that this arrangement appropriately reflects the need for independent standing for the POB. Accordingly, we recommend that the IFAC Board should be permitted to amend the POB's Charter only if the proposed amendment has been accepted by a two-thirds majority of the POB. Furthermore, we also recommend that the initial charter be approved by the POB at its first meeting.

The proposed Charter for the POB furthermore requires the POB to be available for consultation by the IFAC Nominating Committee on its nominations for Chair of those public interest committees for which the POB has oversight responsibilities. In order to further strengthen the role of POB, IFAC should consider requiring consultation with the POB not only for nominations for Chair but also for nominations for the other members of those committees.

The Charter for the US Public Oversight Board includes requirements concerning conflicts of interest in respect of its members and employees and also arrangements to indemnify these individuals, to the full extent authorized by law, for the good faith exercise of judgement in the performance of their assigned duties. There are no corresponding requirements or arrangements in the proposed Charter for IFAC's POB. We are not aware of any reason for this and believe that, for both conflicts of interest and indemnification, it would be beneficial for the standing of the POB if corresponding solutions were introduced for the POB.

The Forum of Firms and the Transnational Auditors Committee

The definition of transnational audits

The definition of "transnational audits" is of particular importance. In the consultative documents, this term is defined to mean "*audits of financial statements which are or may be*

used across national borders; this will [normally]¹ include all companies with listed equity or debt and other major public interest entities such as banks and other financial institutions."

The definition is somewhat unclear, and raises the question of whether major banks will always be included or only if their financial statements are or may be used across national borders. The TAC in its TAC Practice Alert 1 (August 2001) takes the latter view. From a financial stability perspective, it is of course entirely unsatisfactory if major banks and other major financial institutions are not always included within the scope of this definition. On the other hand, it does not seem to be necessary to include smaller banks (e.g., those institutions that clearly are not significant from a financial stability perspective). We recommend that the definition be clarified accordingly.

The firms' commitments and responsibilities

The FOF will include firms that commit themselves to perform so-called transnational audits in accordance with international auditing standards, to comply with the IFAC Code of Ethics and to be subject to a program of quality assurance. The TAC will be the FOF's executive body, and will manage and monitor the peer-based quality assurance review program.

Thus, the firms in the FOF will undertake to conduct all audit assignments that are "transnational" in accordance with the quality requirements stipulated by the FOF.

We believe that this approach is useful and will enhance the standing and use of international auditing standards. An important question is to what degree will this commitment ensure that all audits labelled "transnational" are carried out in compliance with international auditing standards. In many countries, the audits may be done without adequate legal responsibilities for the auditors, without appropriate enforcement and with shortcomings in the area of corporate governance, for example, shortcomings concerning the responsibilities of the board of directors of the audited company for the company's financial statements.

To some extent, it would be possible to compensate for shortcomings of this type by contractually agreed commitments, as suggested in the FOF Constitution. According to the consultative documents, the corrective mechanisms available to the TAC and the FOF consist of Suspension and Exclusion. These types of measures may not prove sufficiently precise in practice, not least in the case of international audit networks, as it may appear disproportional to exclude an entire international network when its local affiliate in one country does not comply with the quality requirements. Furthermore, were exclusion to be applied, what would be the remaining substance of the FOF if circumstances in two countries necessitate the exclusion of two of the big international audit networks? For these reasons, the TAC and the FOF may be reluctant in practice to invoke these powers and may need to have available a range of other disciplinary tools as well as these ultimate sanctions.

Furthermore, there needs to be a clearer statement of the detailed quality control standards that the members of the FOF have agreed to adopt. Without this clarity it will be very difficult to measure the progress that is being made toward ensuring compliance with international accounting and auditing standards.

¹ The word "normally" is included in the definition provided in the POB Charter, but not in the definition provided in the FOF Constitution.

Principles for the International Quality Assurance Review

The quality assurance review program to be applied within the FOF is an important tool for ensuring that the whole approach is meaningful and needs to be designed with significant care. The consultative documents do not elaborate in any great detail on this important aspect, and the subject is largely absent from the statutory documents. We believe that the following important principles should be explicitly stated in the FOF's Constitution:

- (a) A prohibition on back-to-back reviews (i.e., where firm X reviews firm Y and firm Y reviews firm X);
- (b) A limitation on the number of consecutive years that a firm can review another firm (e.g., three years); and
- (c) A requirement that a reviewing firm must have appropriate resources (e.g., industry skills).

In many countries, peer review programs are already established. When that is the case, the International Quality Assurance Review Program will normally need to be coordinated with such programs. It is however important that when this is done, all requirements of the International Quality Assurance Program are fully adhered to.